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DISCRETE TAX ISSUES FOR CLERGY AND RELIGIOUS

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IRS SUMMONS AUTHORITY

Early in 1981, the California Province of the Society of Jesus received a letter from the IRS requesting responses to seven inquiries under threat of revocation of exemption. The first question asked for a detailed description of its activities. The remaining six questions appeared to be directed at unrelated trade or business. The IRS letter, however, did not indicate any belief that the Province was engaged in a particular unrelated trade or business. It did not confine its inquiry to any such activity, nor did it indicate that approval of the Assistant Regional Commissioner had been obtained or was contemplated.

The diocesan attorney[1] responded to the first question because it related to continued exemption, and declined to answer the remaining questions on the ground that the IRS failed to comply with section 7605(c) of the Code[2] and the regulations thereunder. After a lengthy silence, the IRS responded with a form letter thanking the province for its reply and indicating that the information provided was used to determine that the province continued to qualify as an organization exempt from federal income tax under the Code. Since that time, other Church organizations have received similar requests and we have advised them on vari-

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[1] William G. Filice, Esq., of San Jose, California.

[2] I.R.C. § 7605(c) (1976 & Supp. V 1981). Section 7605(c) provides:

> No examination of the books of account of a church . . . shall be made to determine whether such organization may be engaged in the carrying on of an unrelated trade or business or may be otherwise engaged in activities which may be subject to tax . . . unless the Secretary . . . believes that such organization may be so engaged and so notifies the organization in advance of the examination. No examination of the religious activities of such organization shall be made except to the extent necessary to determine whether such organization is a church . . . , and no examination of the books of account of such an organization shall be made other than to the extent necessary to determine the amount of tax imposed by this title.

Id.

ous strategies. The most recent IRS inquiry was sent to a church in New York,[3] and was similar to the California inquiry.

It appears that these inquiries are the result of a random computer kick-out. They are drawn from a list in the Internal Revenue Manual approved for preexamination inquiries of churches.[4] Notwithstanding this fact, it is submitted that the IRS is requesting information in violation of the Code and its own regulations. Responding to such inquiries would effectively waive the protection provided churches under section 7605(c).

The courts are not in accord concerning the scope of section 7605(c) protection. Three cases decided in 1981 illustrate this fact. In May 1981, the Eighth Circuit decided the case of *Baldwin v. Commissioner*,[5] involving a licensed and ordained minister of the Basic Bible Church, who allegedly turned his income over to the Church pursuant to a vow of poverty.[6] Mr. Baldwin had filed a petition for a deficiency redetermination in the Tax Court.[7] The IRS served Baldwin with four interrogatories and requests for production of documents.[8] Mr. Baldwin partially answered the interrogatories but objected to most portions as irrelevant, in violation of section 7605(c), or protected by the first amendment, and as a result refused to produce any of the requested documents.[9] Motions to compel discovery were resolved in favor of the IRS without serious consideration of the substance of Mr. Baldwin's first amendment claims. Since Mr. Baldwin failed to comply, the Tax Court dismissed Baldwin's suit and entered a deficiency judgment against him for an amount exceeding $6,000.[10]

On appeal, Mr. Baldwin argued that section 7605(c) barred the IRS

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[3] Kevin M. Kearney, Esq., of Brooklyn, New York, is the Diocesan Attorney for St. Rosalia's Church, the subject of the IRS inquiry.

[4] *See* Internal Revenue Manual §§ 7(10)70-2, 7(10)71.52 (1977).

[5] 648 F.2d 483 (8th Cir. 1981).

[6] *Id.* at 484-85. Baldwin's 1977 federal income tax return stated that "'all income received'" in that year was given to the Basic Bible Church of America in compliance with a vow of poverty taken by Baldwin. *Id.* at 485.

[7] *Id.* Prior to the filing of a deficiency redetermination by Baldwin in August 1979, Baldwin appeared before the IRS in St. Paul, Minnesota. *Id.* Additionally, Baldwin received a letter from the IRS alleging a deficiency, and statutory notice of a deficiency was issued in June 1979, notwithstanding administrative challenges by Baldwin. *Id.*

[8] *Id.* In November 1979, the Commissioner requested, *inter alia*, "[a] list [of] the dates of all services of the Order . . . and *the names and current addresses of all persons attending each of these services*," *id.* at 485 n.3, and "[all] *records pertaining to cash receipts and disbursements*, including . . . *records of contributions to* [the] *Basic Bible Church . . . or the Order of Almighty God, Chapter No. 7909 . . . .*" *id.* at 485 n.4 (emphasis supplied by court).

[9] *Id.* at 485.

[10] *Id.* at 486.

from discovering much of the information sought.[11] He further argued that he could prove his church was exempt without disclosing the confidential membership lists and sources of financial donations that he asserted to be privileged under the first amendment.[12] Finally, he argued that the IRS had not shown a cogent and compelling need for disclosure that justified infringement of his first amendment rights.[13]

The IRS argued that neither the first amendment nor section 7605(c) justified Mr. Baldwin's failure to comply with the order compelling discovery.[14] It also argued that section 7605(c) limits only the scope of an IRS administrative summons and has no application to requests for discovery under the Tax Court rules.[15] In addition, the IRS argued that even if section 7605(c) did apply to the Tax Court rules, it would not preclude disclosure of the information sought from Baldwin.[16]

The Eighth Circuit did not decide the issue of section 7605(c)'s applicability to the Tax Court rules.[17] The court held that once the taxpayer makes a prima facie showing that the information requested infringes upon an organization's first amendment rights, the burden shifts to the IRS to make an appropriate showing of need for the material.[18] Specifically, disclosure of a group's membership lists could be compelled only by a showing that there was a rational connection between such disclosure and a legitimate government interest, and that the government interest in the disclosure was both cogent and compelling.[19]

The court concluded that Baldwin had made a prima facie case, and that full compliance with the IRS discovery was an arguable infringement on the Church's first amendment associational freedoms.[20] Therefore, the Tax Court decision was vacated and remanded for consideration of Baldwin's first amendment objections to discovery requests. The court did find, however, that the IRS discovery requests for information other than the membership and contributor lists were reasonable.[21]

In November 1981, the District Court for the Eastern District of California decided the case of *United States v. Coates*,[22] an IRS summons

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[11] *Id.*; *see supra* note 2.
[12] 648 F.2d at 486.
[13] *Id.*
[14] *Id.*
[15] *Id.* at 487.
[16] *Id.*
[17] *See id.*
[18] *Id.* (citing United States v. Citizens State Bank, 612 F.2d 1091, 1094 (8th Cir. 1980)).
[19] 648 F.2d at 487 (citing United States v. Citizens State Bank, 612 F.2d 1091, 1094 (8th Cir. 1980)).
[20] 648 F.2d at 488.
[21] *Id.*
[22] 526 F. Supp. 248 (E.D. Cal. 1981).

enforcement case involving the Church of Reflection.[23] The Regional Commissioner had approved an examination of its books of account. The Church vigorously objected.[24] The IRS took the position that it was entitled to examine the books of account of a church upon proper notice for the purpose of reviewing the church's tax-exempt status, as well as for the purpose of determining the presence and amount of any unrelated trade or business income.[25] The IRS admitted, however, that the instant examination involved tax-exempt status only and that the IRS had no basis to believe that the Church was engaged in unrelated trade or business.[26]

The Church contended that section 7605(c) prohibited "*all* examinations of churches except those undertaken pursuant to a Commissioner's 'belief' that the church in question is engaged in an unrelated trade or business."[27] "In other words, [the Church narrowly] construed section 7605(c) as foreclosing the ability of the IRS to conduct examinations of churches solely for the purpose of reviewing their tax-exempt status."[28]

The district court held that section 7605(c) expressly permits examinations for unrelated business income and tax-exempt status.[29] The court, however, drew distinctions based upon the type of examination. It found that examinations of religious activities are permissible only to the extent necessary to determine whether an organization is a church and therefore exempt from taxation, not for the purpose of determining the presence and amount of any unrelated business income.[30] The court further concluded that section 7605(c) permits examination of church books of account only to the extent necessary to determine the presence and amount of unrelated business income.[31] Thus, the examination of the books of account was not permitted solely for the purpose of reviewing tax-exempt status.

The holding in *Coates* is at odds with the holding in *United States v.*

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[23] *Id.* at 249.

[24] *Id.* at 250. Subsequent to the Regional Commissioner's letter approving the District Director's request to examine the Church's books of account, the IRS issued a summons requesting the appearance of a named representative of the Church before the IRS, and the production of certain materials including, "[a]*ll* records pertaining to cash receipts and disbursements. . . . ." *Id.* (emphasis added). The named representative, however, failed to appear before the IRS, and the documents were not produced. *Id.*

[25] *Id.*

[26] *Id.* at 252.

[27] *Id.* (emphasis supplied by court).

[28] *Id.*

[29] *Id.* at 253.

[30] *Id.*

[31] *Id.* at 253-54. The court posited that churches found to have unrelated business income during an examination undertaken solely to determine tax-exempt status, would be "deprived of the protections afforded by § 7605(c)," if the court did not apply section 7605(c) to examinations of tax-exempt status. *Id.* at 254.

Freedom Church[32] in which the First Circuit rejected the argument that section 7605(c) prohibited IRS examination of books of account to determine tax-exempt status of an organization that claimed to be a church.[33] The First Circuit placed reliance upon the regulations under section 7605(c),[34] which clearly permit the examination of books of account solely for the purpose of reviewing tax-exempt status. The district court declined to follow the First Circuit on the ground that regulations not in harmony with the plain language of an underlying statute cannot serve as a guide in statutory construction. The court ruled that the section 7605(c) regulations were invalid to the extent they conflicted with the statute.[35] Therefore, enforcement of the IRS summons was denied insofar as it sought production of the Church's books of account.[36] The summons was ordered enforced, however, with respect to the Church's corporate minute books, because minute books are not considered books of account and the IRS had made an adequate showing that the examination of the minute books was necessary to reach a determination as to the continuing tax-exempt status of the Church.

In *United States v. Dykema*,[37] the Seventh Circuit upheld enforcement of an IRS summons of church records in the course of an investigation of a church pastor's individual tax liability.[38] The summons called for fourteen comprehensive categories of records belonging to the Christian Liberty Church.[39] The stated purpose of the summons was threefold: to enable a determination as to whether the Church was an exempt organization under section 501(c)(3) and hence a proper recipient of deductible contributions; whether it was liable for any unrelated business income tax; and whether the pastor individually was liable for any tax.[40]

Without difficulty, the court concluded that the pastor's individual tax liability was to be investigated and established in the same manner as that of any other taxpayer.[41] Therefore, records in the hands of other parties, including his church employer, could be examined if relevant to his

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[32] 613 F.2d 316 (1st Cir. 1979).

[33] *Id.* at 324.

[34] *See id.*; *see also* Treas. Reg. § 301.7605-1(c)(2) (1979). Section 301.7605-1(c)(2) provides in relevant part:

> No examination of the books of account of an organization which claims to be a church . . . shall be made . . . except to the extent necessary (i) to determine the initial or *continuing* qualification of the organization [as tax exempt].

Treas. Reg. § 301.7605-1(c)(2) (1979) (emphasis added).

[35] 526 F. Supp. at 255.

[36] *Id.*

[37] 666 F.2d 1096 (7th Cir. 1981), *cert. denied*, 102 S. Ct. 2257 (1982).

[38] *Id.* at 1098, 1104.

[39] *Id.* at 1098.

[40] *Id.*; *see* I.R.C. § 501(c)(3) (1982).

[41] 666 F.2d at 1098-99.

individual tax liability.[42] The court further held that IRS authority to obtain such records would not be diminished even if its investigations disclosed unreasonable and excessive payments to the pastor of the type that would constitute inurement, which might adversely affect the Church's exempt status.[43] The court then rejected the district court's conclusion that a stricter, "truly necessary" standard be followed.[44] Finally, the court concluded that the section 7605(c) restriction applies only to unrelated business income and does not restrict the scope of examination with respect to other issues, including whether an organization is exempt.[45] The summons therefore was ordered enforced.

These cases evidence the tensions between opposing interpretations of section 7605(c). On the one extreme, its restrictions apply only to the books of accounts with respect to liability for unrelated trade or business income tax, and all other examinations may be conducted freely. On the other extreme, is the argument that section 7605(c) prohibits *all* examinations of churches except those undertaken pursuant to the Commissioner's belief that a church is engaged in unrelated trade or business. In practice, courts have resolved these tensions by interpretations somewhere between the two extremes.

While Church organizations should continue to assert a broad section 7605(c) privilege, it is important to bear in mind that the courts have upheld more narrow interpretations.

CHANGE IN SOCIAL SECURITY POSITION ON VOW OF POVERTY

On September 25, 1981 the Social Security Administration issued a notice advising all state social security administrators of a change in the social security status of religious who are under vows of poverty and employed outside their orders.[46] The new policy requires states and interstate instrumentalities to report wages and make FICA contributions

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[42] *Id.* at 1098.

[43] *Id.* at 1099.

[44] *Id.* The court opined that the truly necessary standard was based upon the provision under section 7605(c) "that examination of the books of account of a church shall be made only 'to the extent necessary' to determine the amount of tax on unrelated business income." *Id.* (quoting I.R.C. § 7605(c) (1982)). The *Dykema* court, however, concluded that examinations of records in the hands of third parties, are "subject only to the usual requirements that 'the investigation [have] a legitimate purpose, that the inquiry . . . be relevant to the purpose that [the IRS does not already have the information sought], and that the administrative steps required by the Code have been followed,' " notwithstanding the fact that the third party is the church employer of the person under investigation. 666 F.2d at 1098-99 (quoting United States v. Powell, 379 U.S. 48, 57-58 (1964)).

[45] 666 F.2d at 1101-02.

[46] *See* Social Security Administration Program Policy Statement No. 61 (September 15, 1981) [hereinafter cited as SSA Policy Statement].

with respect to such services beginning January 1, 1982.[47] The fact that services are performed at the direction of the order is no longer material.[48]

Originally, the Social Security Administration had taken the view that all services performed by a member of a religious order were excluded from the definition of employment as long as they were performed at the direction of the order.[49] According to the new policy, a member of a religious order who works outside the order in an employment relationship with a third party is considered an employee of the third party and not an agent of the order.[50] When a member, however, is directed to perform services for another agency of the supervising church, or an associated institution, the member will be considered an agent of the order.[51] The new policy also provides that members of religious orders affected by this change can receive social security wage credit for past periods by contacting their respective social security offices, and no contribution liability would result.[52]

The new policy brings the Social Security Administration in line with the IRS position announced in Revenue Ruling 77-290.[53] It is, however, in direct conflict with social security regulations.[54] Administrative efforts to have the policy revoked were completely fruitless.

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[47] *See id.* at 1-2.

[48] *See id.*

[49] *See id.* at 1; *see also* Treas. Reg. § 31.3121(b)(8)-1(d) (1979). The original policy was the result of the belief that a member who had taken a vow of poverty would be under the direct control of the order in performing his services, regardless of who his actual employer was. *See* SSA Policy Statement, *supra* note 46, at 1. The Social Security Administration noted, however, that in reality, the order relinquishes control to the third-party employer, and, thus, a change was necessary in order to bring social security policy in line with the actual situation. *See id.*

[50] *See* SSA Policy Statement, *supra* note 46, at 2.

[51] *See id.*

[52] Letter from William F. Cooper, Acting Director, Office of Insurance Programs to State Social Security Administrators (September 15, 1981) (discussing Social Security Administration Policy Statement No. 61).

[53] Rev. Rul. 77-290, 1977-2 C.B. 26. Rev. Rul. 77-290 provides that a member of a religious order who has taken a vow of poverty and is employed by a third party, must include any compensation received by the order from the third party in her gross income, notwithstanding the fact that she was directed by the religious order's superiors to obtain the employment. *See id.* Indeed, the compensation earned by the member is considered wages, and, consequently, is subject to FICA and income tax withholding. *See id.* Under these circumstances the member is regarded as an agent of the third party, not the religious order. *See id.* Conversely, when a member of a religious order who has taken a vow of poverty is instructed to provide services for another agency of the church, the member is not required to include the compensation paid to the order in her gross income, and the compensation is not considered wages subject to FICA and income tax withholding. *See id.* The member in this situation is deemed an agent of the order. *See id.*

[54] *See supra* note 49 and accompanying text.

LITIGATION IN VOW OF POVERTY CASES: STATUS REPORT

There are five cases pending in the Court of Claims involving income tax and FICA liability of religious who are subject to vows of poverty and obedience and employed in institutions outside the Church. Two cases have been filed to challenge the position that the religious are subject to social security withholding on remunerations from such employment. The first case involves a sister employed at the Nampa School District in Nampa, Idaho,[55] and the second concerns a sister who served with the St. Louis County Department of Community Health and Medical Care.[56] Both suits seek to recover social security withholding and to establish precedent that would overturn Revenue Ruling 77-290.[57]

If the social security cases are successful, litigation strategy calls for moving forward with three income tax liability cases. The province of St. John the Baptist of the Order of Friars Minor of Cincinnati has filed two cases on this issue.[58] The first involves a chaplain at the National Leprosarium in Carville, Louisiana,[59] the second a chaplain at the Longview State Hospital in Cincinatti, Ohio.[60] The third case involves a Jesuit in the Maryland Province, teaching in the Department of Religious Studies at the University of Virginia.[61] All three cases seek refunds of income tax and establishment of precedent overturning Revenue Ruling 77-290 on the income tax issues, at least for services performed for institutions described in section 501(c)(3).

REPORTING BY CATHOLIC INSTITUTIONS OF SALARIES TO RELIGIOUS WHO ARE UNDER A VOW OF POVERTY

Regardless of whether the litigation in the Court of Claims is successful, Revenue Ruling 77-290 concludes that religious who are subject to the vows of poverty and obedience and employed in Catholic institutions are not liable for income tax or FICA tax on their salaries because they receive remuneration not as individuals but as agents of their orders. Problems arise, however, when Catholic institutions report salaries paid to the religious as if the salaries were income to them individually. As a

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[55] *See* Reed v. United States, No. 16-82T (Ct. Cl. July 30, 1982) (available Feb. 28, 1983, on LEXIS, Genfed library, Ct. Cl. file). Shortly after this address at the meeting of diocesan attorneys, the Court of Claims rendered a judgment in favor of the plaintiff. *See id.* Special attention, therefore, should be paid to the income tax liability cases. *See infra* notes 60-61 and accompanying text.

[56] Sampson v. United States, No. 17-82T (Ct. Cl. filed Jan. 12, 1982).

[57] *See* Rev. Rul. 77-290, 1977-2 C.B. 26.

[58] *See infra* notes 59-61 and accompanying text.

[59] Kircher v. United States, No. 694-81T (Ct. Cl. filed Dec. 1, 1981).

[60] Waldschmidt v. United States, No. 695-81T (Ct. Cl. filed Dec. 1, 1981).

[61] Fogarty v. United States, No. 54-82T (Ct. Cl. filed Feb. 1, 1982).

result, IRS audits are triggered by what appears to be a failure on the part of the religious to file an income tax return. When a Catholic institution reports remuneration paid on account of the service of a religious on Forms W-2 and W-3, the religious has the burden of proving that the income reported is not his or hers. Under Revenue Ruling 77-290, that income is the income of the religious institution. Many needless tax audits could be avoided by correcting this problem at the source, the Catholic institution.

First, religious should provide whatever documentation the Catholic institution requires so as to ensure that he is there with proper permission of his order and that the funds come under the control of the order. The best evidence of such control is a direct payment of money to the institution for the services of the religious. Another acceptable method is the issuance of a paycheck jointly to the institution and the religious, but using the federal identification number of the institution on the account. A less acceptable system is to issue the paycheck in the name of the religious and a 1099 to the religious order, rather than the paycheck in the name of the religious and a W-2 to the individual. This recognizes that the check represents income to the institute and not to the individual. Under each method, Form 1099 should be issued to the order. No contract between the order and the religious is required. This does not mean that money paid to religious cannot be considered a salary expense of the Catholic institution. It merely requires a certain level of sophistication in payroll systems.

REPORTING PRIESTS' INCOME—THE *Rowan* CASE

In August 1981, a memorandum[62] was distributed which included a discussion on the *Rowan*[63] case, in which the Supreme Court invalidated FICA and the Federal Unemployment Tax Act (FUTA) regulations, interpreting the term "wages" to include the value of meals and lodging provided employees for the convenience of their employer.[64] The *Rowan* case does not affect the computation of net income from self-employment

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[62] Memorandum from Wilfred R. Caron, General Counsel, United States Catholic Conference, to all (Arch)bishops, Diocesan Attorneys, State Conference Directors, and Fiscal Managers (Aug. 13, 1982).

[63] Rowan Cos. v. United States, 452 U.S. 247 (1981).

[64] *Id.* 249-50, 263. The Supreme Court in *Rowan*, held that the FICA and FUTA definitions of "wages" were intended by Congress to comport with the income tax withholding definition, wherein meals and lodging, provided for the convenience of the employer, are excluded from "wages." *Id.* at 250, 263; *see* Treas. Reg. § 31.3401(a)-1(b)(9) (1960). ("[t]he value of any meals or lodging furnished to an employee by his employer is not subject to [income-tax] withholding if the value of the meals or lodging is excludable from the gross income of the employee").

by diocesan priests. Self-employment tax is based on "net earnings from self-employment" rather than "wages." Net earnings from self-employment is statutorily defined to include the value of meals and lodging furnished to priests notwithstanding the exclusion of such value from gross income and from income tax withholding.[65] Therefore, the *Rowan* case does not apply to the situation of diocesan priests because two different statutory definitions are involved. Diocesan priests should continue to include the value of their meals and lodging in the computation of their net earnings from self-employment.

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[65] I.R.C. § 1402(a)(8) (1982).